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Entrepreneurs' relief on the chopping block

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Having promised vaguely to ‘review and reform’ entrepreneurs’ relief (‘ER’) in their election manifesto, the Conservatives now look increasingly likely to scrap the relief altogether. In a recent statement reported by The Times, Boris Johnson said the Treasury was ‘fulminating’ against the relief, leading to widespread speculation that it will be abolished in the coming Budget on 11 March, with the change potentially being effective from that date. Whether the analysis of the ineffectiveness of the relief in achieving its stated aim of stimulating entrepreneurial activity is right or wrong, those taxpayers holding on to accrued gains which could benefit from ER should review their position now in anticipation of losing access the relief altogether.

ER operates to reduce the rate of capital gains tax (‘CGT’) payable on qualifying disposals to 10%, half the normal higher rate of 20%, with a lifetime limit on the relief of £10 million of gains. The relief can cover disposals of shares or securities in a trading company, as well as the transfer of the whole or part of a business, and is subject to various conditions such as minimum ownership requirements, that the taxpayer is an officer or employee of the company and that these requirements are satisfied for a period of two years prior to disposal. Whether the requirements are satisfied is not always straightforward and a full analysis is advisable in each case.

Banking ER now

Entrepreneurs who would currently qualify for ER may wish to consider whether it is worth triggering a taxable event now on their accrued gains to ensure that they can benefit from the lower 10% rate. The obvious way to trigger a CGT liability is to sell the asset which has increased in value, but this may not be practical or desirable in the timeframe or circumstances, particularly for individuals running their own businesses.

Another method of triggering the CGT charge would be to transfer the asset to another person (other than a spouse or charity). It is a common misconception that a gift to one’s children does not trigger CGT, but in fact it does. By gifting, for example, shares in a company to one’s children, ER could be claimed on the resulting taxable gain if the conditions are met. The obvious downside of such a transfer is that it results in a ‘dry’ tax charge (ie no sale proceeds to fund the tax). Another concern, depending on the circumstances, could be that it may result in shifting control of the company away from the donor at an inopportune time. This approach does not work for gifts to one’s spouse or to a charity, which are exempt from CGT.

An alternative method of triggering the gain would be to transfer the asset on trust. A transfer on trust is a disposal for the purposes of CGT. As a privately held business asset, the value transferred on trust would likely benefit from business property relief from inheritance tax, meaning it would not be subject to the usual 20% inheritance tax ‘entry charge’ imposed on lifetime transfers on trust. Through the choice of appropriate trustees, the problem of transferring control of the business to one’s children at an inappropriate time would also be mitigated.

One’s family and professional circumstances will heavily influence the approach taken, if any, but the first important consideration when seeking to trigger a CGT charge is liquidity.

Lessons to be wary of: the liquidity trap, market risk and avoiding ‘schemes’,

Before any action is taken, it is essential to be sure that you have enough liquidity to cover the CGT liability that will arise from the disposal. When an asset is transferred gratuitously by way of gift, whether to an individual or on trust, the transferor receives nothing in return from which to pay the tax and will need to resort to other funds to cover the liability.

Warnings from history are instructive. In anticipation of the 2008 abolition of CGT taper relief many taxpayers undertook planning to rebase their gains in order to take advantage of the more generous relief which was ceasing to apply. This was particularly attractive to business owners who anticipated an exit from the business but were unable to complete the sale before the date that taper relief would cease to apply. However, some individuals found that they did not have enough liquidity to afford the resulting tax bill, resulting in insolvency issues. This issue was compounded in some cases by the 2008-9 financial crash, which prohibited those individuals from footing their tax bill by selling the asset which had triggered the charge at the anticipated value, if at all. With an eye on Brexit becoming a reality at the end of this month and Bank of England policymakers' hint at rate cuts, business owners should think hard before rushing into planning for tax purposes alone.

In retrospect, planning of the kind seen prior to the 2008 abolition of taper relief often employed somewhat artificial schemes to trigger gains which would likely be challenged nowadays, under the General Anti-Abuse Rule (GAAR). In this context, it would be unsatisfactory for any rebasing exercise undertaken now to be through some wholly artificial means.

If, however, there is an intention, as part of existing estate planning considerations, to transfer value to the next generation, or a sale to third parties is close to becoming a certainty but not likely to complete before the Budget, undertaking planning at this stage may well be merited – and could reduce the ultimate tax bill.

In light of this, entrepreneurs and business owners will want to review their position and plan carefully before any future abolition of the relief.

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